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Isla del Encanto – Introducing Boricua Split Dollar

By now it should already be well that I grew up in the Panama Canal Zone. However, my Latin "thing" didn't happen until I was in the 10th grade. One of my football teammates played congas in a Salsa band in Panama City. Another baseball teammate and friend whose parents were Puerto Rican and Panamanian (the perfect genes for being a Salsero!) was a huge fan of the Fania All-Stars. The Fania All-Stars were a gathering of the best recording acts in Afro-Cuban (Aka Salsa) signed with the Fania record label. In the decade of the 1970s, anybody who was anybody in Afro-Cuban music (aka Salsa) was signed with Fania Records.

One of my big regrets as a cadet at West Point was missing the opportunity to see the Fania All-Stars perform at Madison Square Gardens, the night before I went home for Christmas break. For the record, I met Celia Cruz when she was alive and saw her perform in Miami and the Bronx with Johnny Pacheco and Tito Puente. The Bronx concert should get me extra credit! I have corresponded with Willy Colon. Are you impressed yet? One of the best things was seeing my older brother Willy move on Jimmy Hendrix to discover this great music. If you love horns, it does not get better than classic salsa. For exceptionally great horns, I urge you to listen to *Orquesta de la Luz*, a salsa band from Japan that was the rage in the decade of the 1990s.

This article focuses on a combination of techniques, the use of a Puerto Rican tax-exempt company and the loan method of split dollar life insurance. What's different in this approach is the fact that the business owner does not need to relocate to Puerto Rico. However, I am not going to trace the path the way that I usually do in my articles to legally accomplish the tax benefits of Puerto Rico without relocation. This information is the "secret sauce" that taxpayers need to pay for. Nothing personal, just business! The combination of the loan method of split dollar provides a mechanism for repatriating profits from the Puerto Rican tax exempt company to a trust-owned life insurance for the taxpayer's benefit.

Puerto Rican Tax Incentives

A. Overview

Puerto Rico has always benefited in the past from offering corporations a myriad of tax incentives for creating Puerto Rican operations. Puerto Rico has played an important part in the global tax planning of many large multinational corporations particularly pharmaceutical companies. Large corporations have effectively utilized double tax treaties for decades to minimize their global taxation. Double tax treaties have facilitated foreign taxpayers in their inbound investments within the United States. However, American individual and small business taxpayers have not had the same opportunity to utilize offshore corporations due to the tax rules dealing with controlled foreign corporations and passive foreign investment companies and foreign trusts. The U.S. government has tried to find and close all offshore planning opportunities.

The case of Puerto Rico is an interesting one. As a commonwealth, the Island has always teetered between statehood and independence. More recently, a combination of devastating events including the Island's bankruptcy, a hurricane and Covid 19, Puerto Rico is still standing tall and fighting for its survival. The Puerto Rican government introduced an incredible tax incentive program in 2012 to attract investment on the Island. At the same time, Puerto Ricans were moving to Orlando and Tampa, "Gringos" were moving to San Juan. Despite the setbacks (bankruptcy, hurricane, and global pandemic), the programs have shown promise. In my view, the Number 1 problem, is that the business owner or investor cannot make the sale to the spouse to move to Puerto Rico. No one would ever turn their back on significant tax incentive programs but for the dilemma, " How do I convince my spouse to move?"

Sophisticated tax planning has created a path to achieving this result. A taxpayer from Birmingham, Alabama can benefit from a Puerto Rican tax incentive program by transferring key functions within his business to Puerto Rico without relocating to Puerto Rico. The Puerto Rican exempt company is taxed at only four percent with no Federal or state taxation. Furthermore, the business owner can repatriate the profits of the Puerto Rican exempt company without taxation. No one had to learn Spanish, and no one had to learn to dance! More importantly, no one goes to jail!

B. Puerto Rican Tax Basics

Two important pieces of legislation were passed by the Puerto Rican legislature in 2012. Both the Export Services Act (Act 20) and the Individual Investors Act (Act 22) were signed into law by the Governor of Puerto Rico on January 17, 2012. In July 2019, the Puerto Rican legislature passed Act 60 which consolidated the programs and added important property and municipal tax benefits.

The definition of a U.S. person under §7701(a) (30), however, does not include Puerto Rican entities. As a result, a Puerto Rican entity is not subject to U.S. income taxation unless the entity is engaged in a trade or business within the United States and its income is considered effectively connected income, or investment income that would be subject to a withholding tax under §871 (unless an exemption for portfolio interest under §881(a) applies).

Under §933, bona fide residents of Puerto Rico who have Puerto Rico-sourced income are exempt from U.S. taxation. Section 937 defines a bona fide resident for tax purposes. A person is a Puerto Rican resident for tax purposes if the person is present in Puerto Rico for at least 183 days during the taxable year and he or she does not have a tax home outside Puerto Rico and does not have a closer connection to the U.S. or a foreign country than to Puerto Rico.

For Federal income tax purposes, a taxpayer will be considered a bona fide resident of Puerto Rico if the taxpayer meets the following: (i) the physical presence test (generally spending 183 days in PR, or less than 90 days in the U.S.); (ii) the tax home test; and (iii) the closer connection test for the entire taxable year which means that the taxpayer can't have stronger personal connections to another jurisdiction that is not Puerto Rico, as prescribed in the regulations promulgated under Section 937 of the Internal Revenue Code.

(1) The Individual Investor's Act

Under the Individual Investors Act, neither capital gains (long-term or short-term), interest, nor dividends are subject to Puerto Rican taxation. Dividend income is subject to U.S. federal income taxation for U.S.-sourced dividend income, as is interest income unless the interest income is exempt under the portfolio interest exemption. Long-term capital gains derived by the resident individual investor that (1) were deemed to have accrued before the individual became a Puerto Rican resident and (2) are recognized within the first 10 years after the date the individual becomes a resident, will be taxed at a 10 percent rate.

If the gains are recognized after the 10-year period but before January 1, 2036, the gains will be taxed at a 5 percent rate. Gains considered to have accrued after the investor becomes a Puerto Rican resident will receive a 100 percent exemption. Dividend and portfolio interest income are exempt from Puerto Rican taxation under the new law.

Legislation in July 2017 added a requirement for each decree holder to make an annual donation of $5,000 to a recognized Puerto Rican not-for-profit organization.

(2) The Export Services Act

A business that relocates to Puerto Rico can significantly reduce its tax liability provided that the Puerto Rican entity is not engaged in a U.S. trade or business. The top U.S. corporate tax rate in 2018 is 21 percent at the Federal level. Assume another 5-8 percent at the state level. Many pass-through businesses will qualify for the new 20 percent business deduction under IRC Sec 199A. However, most professional service companies will not qualify for this deduction. These businesses might be well served to evaluate Act 20 status.

Under Puerto Rico's Export Services Act, the corporate tax rate is flat four percent. Additionally, shareholders who relocate to Puerto Rico will have a 100 percent exemption on corporate distributions received from the Puerto Rican company.

Under the Export Services Act, services that are directed to foreign markets may generate income that will qualify for the special tax rate. Services for foreign markets include services performed for non-resident individuals and businesses.

Overview of Loan Regime Split Dollar

a. Loan Regime Split Dollar Basics

The primary planning objective of the loan regime method of split dollar is to provide the hedge fund manager with low-cost death protection and equity buildup in the cash value. In the loan regime, the hedge fund manager is the applicant, and owner of the policy and collaterally assigns an interest in the policy cash value and death benefit to the employer equal to its cumulative loans plus any accumulated interest payments. Better yet, a family trust (irrevocable) established in a jurisdiction like Nevada, South Dakota, Wyoming, or Alaska is a better solution for asset protection purposes. Ownership within the Trust removes the policy from the reach of personal and business creditors.

In the split dollar realm, the Puerto Rican exempt company and taxed at four percent in Puerto Rico, is the sponsor of a split dollar arrangement. The Company provides a series of loans to the trustee of the family trust to all or most of the premiums. The loans are not treated as taxable to the business owner provided the loan terms are arms-length in nature. The loans are not taxable gifts where the loans are extended to the trustee of a family trust providing that there is an adequate interest rate.

IRS Notice 2007-34 describes the application of Section 409A to certain split dollar life insurance plans. In general, Section 409A* does not apply to non-equity endorsement or non-equity collateral assignment split dollar plans or loan regime collateral assignment split dollar plans, unless the employer agrees to forgive the loan, waive payments, etc. for purposes of bringing that plan into compliance with 409A without losing the split dollar grandfathering.

Case Study

Al Smith, age 50, is the owner of a small manufacturing in Birmingham, Alabama. Al's company is very profitable. It operates as a S corporation. Al would like to reduce his operating expenses and tax burden without having to relocate to Puerto Rico. Al enters into a service agreement with a Puerto Rican exempt company which is taxed at 4%. The company subject to transfer pricing considerations, provides sales and marketing as well as procurement services for the company. The service contract is equal to 30% of the gross revenue of Al's operating company. The service fee expenses are tax deductible and taxed at 4% to the PR exempt company. The net revenue to the PR exempt company is $3 million which will be taxed at 4% for PR purposes and not taxed for Federal or state purposes. The Company has the option of repeating the loan method process in Year 2 and subsequent years.

The projected loan amount is $3 million in Year 1. The loan will be an arms-length loan at the current long-term AFR of 1.0percent. The loan is a recourse loan between the Corporation and the Al's Trust. The trustee of an irrevocable trust created by Al's wife is the applicant, owner, and beneficiary of a PPLI policy insuring Al's life.

The policy has a $15 million death benefit and projected premiums of $750,000 per year for four years. The Corporation will have a collateral assignment interest in the cash value and death benefit equal to the amount of the loan plus any accrued interest. The Trust will own the excess cash value and death benefit more than the collateral assignment interest in the policy. The policy is a non-modified endowment contract which means that loans and withdrawals from the policy will receive tax-free treatment to the trustee of the Smith Family Trust.

Acme Life, a specialty life insurer in Bermuda, issues a PPLI contract featuring a separately managed account. Hector Heathcoat, an established money manager and friend of Al's, is appointed by Acme to manage the investment account within the policy. The trustee transfers the entire amount of the loan to Acme who maintains the premiums for future years in a premium deposit account.

The Trustee has the discretion as trustee to request policy loans and withdrawals and distribute the proceeds to Al on a tax-free basis. The policy within the Trust is beyond the reach of Al's personal and business creditors. The policy death benefit will receive income and estate tax-free treatment. The proceeds will also be multi-generational. The trustee pays the annual interest on the $10 million loan at a rate of 1.12 per year. The annual interest payment is $112,000. The loan term is thirty years. The projected growth rate within the policy is 8 percent.

The planning provides additional death benefit only (DBO) option for provides that the PR exempt company will make a lump sum payment to Al's family trust if Al dies while the split dollar plan is in effect. The amount of the DBO benefit is equal to the amount that the Corporation receives from the death benefit portion of its collateral assignment interest in the policy. The payment from the Corporation to the Trust is treated as taxable income. Nevertheless, it is a substantial benefit.

The planning also calls for a termination or rollout of the split dollar plan after the policy is funded using the leveraged split dollar rollout technique. The leveraged split dollar rollout is a method to terminate an existing loan regime split dollar arrangement at a significant discount. In the loan regime, the business as the lender receives a restricted collateral assignment interest in the life insurance policy's cash value and death benefit equal to the value of the loan plus any accrued interest. The collateral assignment interest is restricted until the earlier of the insured's death, termination of the split dollar arrangement or surrender of the underlying policy. The value of the collateral assignment note is discounted due to this restriction.

At some point, the policyholder decides to terminate the split dollar arrangement by purchasing the lender's restricted collateral assignment interest in the policy. A valuation specialist value the note receivable for valuation purchases. Due to the restriction, the receivable is likely to be discounted. These discounts depend upon a variety of a variety of actuarial and financial factors but generally average between 65-95 percent largely driven by the age and life expectancy of the insured. Following the purchase of the split dollar receivable from the lender, the split dollar agreement is terminated. The policyholder uses a tax-free policy loan or withdrawal to purchase the note from the lender.

Following the termination of the split dollar arrangement, the policy is wholly owned within the Trust beyond the reach of personal and business creditors. The trustee may tax-free loans and withdrawals and provide tax-free distributions from the trust to Al and his family. The death benefit will receive income and estate tax-free treatment at Al's death.

Summary

At the outset of this article, I cited as one of the biggest obstacles the fact that the business owner's spouse is unwilling to move to Puerto Rico. Under the Doctrine of *When Momma Ain't Happy, Ain't Nobody Happy*, most business owners just won't make the leap from Sweet Home Alabama to San Juan. Clearly, it is not a question of resentment against reduced taxation.

Under this scenario, the taxpayer will be able to achieve significant accumulation in a Puerto Rican exempt Company without the imposition of Federal and state taxation. The article coordinates two tax planning techniques to reduce current taxation and accumulate wealth in a tax efficient manner while protecting assets from creditors.

At the end of the day, the business owner will never have to take Salsa dancing lessons or learn Spanish, unless he wants to. Mrs. Business Owner will be able to stay home and not upset her current lifestyle and miss her grown children through any perceived hard duty in Puerto Rico.

The combination of ideas provides taxation at 4% while split dollar life insurance provides a combination of tax and planning benefits that prior deferred compensation arrangements never provided:

1) Asset Protection
2) Tax-free accumulation
3) Tax-free income during lifetime
4) Income and estate tax free benefits at death
5) Multi-generational benefits for the family

The next move is yours!